



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9851]

RIN 1545-BN55

Guidance Under Section 851 Relating to Investments in Stock and Securities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the income test used to determine whether a corporation may qualify as a regulated investment company (RIC) for Federal income tax purposes. These final regulations provide guidance to corporations that intend to qualify as RICs.

DATES: Effective date: These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability date: For the date of applicability, see §1.851-2(d).

FOR FURTHER INFORMATION CONTACT: Matthew Howard at (202) 317-7053 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) relating to RICs. Section 851 of the Internal Revenue Code (Code) sets forth requirements for qualifying as a RIC.

On September 28, 2016, a notice of proposed rulemaking (REG-123600-16) was published in the **Federal Register** (81 FR 66576) under section 851. No public hearing was requested or held. Written or electronic comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision containing final regulations. The revisions to the proposed regulations are discussed in the Summary of Comments and Explanation of Revisions.

Summary of Comments and Explanation of Revisions

In response to the notice of proposed rulemaking, the IRS received five written comments that are available for public inspection at www.regulations.gov or upon request.

A. Revisions Due to Statutory Changes

The notice of proposed rulemaking proposed revisions to §1.851-2(b)(1), which had been published in the **Federal Register** (25 FR 11910) on November 26, 1960, as part of TD 6500 (1960 final regulations). The proposed revisions would conform §1.851-2(b)(1) to several changes to the statutory text of section 851(b)(2) enacted after the 1960 final regulations were published. See Pub. L. 95-345, §2(a)(3), 92 Stat. 481, 481 (1978); Tax Reform Act of 1986, Pub. L. 99-514, §653(b), 100 Stat. 2085, 2298 (1986); Taxpayer Relief Act of 1997, Pub. L. 105-34, §1271(a), 111 Stat. 788, 1036 (1997). No comments were received on these proposed revisions. Accordingly, the final regulations adopt the revisions to §1.851-2(b)(1) as proposed.

B. Defining Securities

In the notice of proposed rulemaking, the Department of the Treasury (Treasury Department) and the IRS determined that the IRS should no longer issue private letter rulings on questions relating to the treatment of a corporation as a RIC that require a determination of whether a financial instrument or position is a security under the Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 – 80a-64 (2016)) (1940 Act). Contemporaneously with the publication of the notice of proposed rulemaking, the Treasury Department and the IRS issued Rev. Proc. 2016-50 (2016-43 I.R.B. 522), which provides that the IRS ordinarily will not issue rulings or determination letters on any issue relating to the treatment of a corporation as a RIC that requires a determination of whether a financial instrument or position is a security under the 1940 Act. One commenter recommended that the IRS not add this issue to the no-rule list and that the IRS continue to consider ruling requests in situations in which the status of an investment as a security under section 2(a)(36) of the 1940 Act is sufficiently clear under the language of the 1940 Act or under relevant guidance from the SEC. In issuing the notice of proposed rulemaking and Rev. Proc. 2016-50, the Treasury Department and the IRS considered the issues, the resource constraints of the IRS, and the jurisdiction of the SEC under the 1940 Act and determined that the IRS ordinarily should not issue rulings that require a determination by the IRS of whether a financial instrument or position is a security under the 1940 Act. If the security status of an instrument is sufficiently clear under the 1940 Act, or if the SEC has issued relevant guidance, any other requested ruling may be considered by the IRS subject to other limitations applicable to all ruling requests. See,

for example, section 6 of Rev. Proc. 2019-1 (2019-1 I.R.B. 1, 18). The IRS therefore declines to adopt the suggestion and has continued to include the issue described in Rev. Proc. 2016-50 in the list of areas in which rulings or determinations letters will not ordinarily be issued. See, for example, section 4.01(44) of Rev. Proc. 2019-3 (2019-1 I.R.B. 130, 140).

In the notice of proposed rulemaking, the Treasury Department and the IRS also requested comments as to whether Rev. Rul. 2006-1 (2006-1 C.B. 261), Rev. Rul. 2006-31 (2006-1 C.B. 1133), and other previously issued guidance involving determinations of whether a financial instrument or position held by a RIC is a security under the 1940 Act should be withdrawn. Commenters recommended that Rev. Rul. 2006-1 and Rev. Rul. 2006-31 not be withdrawn because RICs rely on those rulings to invest with confidence in certain derivatives on stocks and securities. The commenters suggested that withdrawal of those rulings would create confusion and uncertainty with respect to investments by a RIC. After consideration of the comments, the Treasury Department and the IRS have decided not to withdraw the revenue rulings at this time.

C. Inclusions Under Section 951(a)(1) or 1293(a)

In certain circumstances, a U.S. person may be required under section 951(a)(1) or 1293(a) to include in taxable income certain earnings of a foreign corporation in which the U.S. person holds an interest, without regard to whether the foreign corporation makes a distribution to the U.S. person. The Tax Reduction Act of 1975, Pub. L. No. 94-12, § 602, 89 Stat. 26, 58 (1975 Act), substantially increased the overall amount of these inclusions. Because these inclusions are not dividends (even if accompanied by a corresponding distribution), they would have been non-qualifying

gross income for RICs. However, the same subsection of the 1975 Act that increased the amount of inclusions also amended section 851(b). This amendment provided that an inclusion under section 951 was treated as a dividend (and therefore qualifying income for purposes of section 851(b)(2)) if the inclusion was accompanied by a distribution out of the earnings and profits of the taxable year that are attributable to the amounts so included. The Tax Reform Act of 1986, Pub. L. No. 99-514, § 1235, 100 Stat. 2085, 2575 (1986 Act), provided the same dividend treatment for amounts included in income under section 1293(a). The current version of the language added by the 1975 and 1986 amendments provides:

For purposes of [section 851(b)(2)], there shall be treated as dividends amounts included in gross income under section 951(a)(1)(A) or 1293(a) for the taxable year to the extent that, under section 959(a)(1) or 1293(c) (as the case may be), there is a distribution out of the earnings and profits of the taxable year which are attributable to the amounts so included.

The 1986 Act also added to the description of a RIC's qualifying income "other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in . . . stock, securities, or currencies."

The amendments to section 851(b) by the 1975 Act and the 1986 Act unambiguously condition dividend treatment of an inclusion under section 951(a)(1)(A) or 1293(a) on a distribution from the foreign corporation's earnings and profits attributable to the amount included. Absent a distribution, there is no support in the Code for treating an inclusion under section 951(a)(1)(A) or 1293(a) as a dividend under section 851. The proposed regulations would, therefore, clarify that an inclusion under section 951(a)(1)(A) or 1293(a) is treated as a dividend for purposes of section 851(b)(2) only to the extent that the distribution requirement in section 851(b) is met. All

five commenters acknowledged that the distribution requirement for dividend treatment in the proposed regulations is consistent with the statutory language in section 851(b). Accordingly, the final regulations adopt the clarification of the distribution requirement as proposed.

The proposed regulations, however, also would provide that dividend treatment is the only manner in which an inclusion under section 951(a)(1) or 1293(a) may be qualifying income. That is, under the proposed regulations, for purposes of section 851(b)(2) neither of these inclusions would be other income derived with respect to a RIC's business of investing in stock, securities, or currencies (Non-qualifying Income Proposal). Commenters unanimously recommended that the Treasury Department and the IRS exclude the Non-qualifying Income Proposal from the final regulations. Commenters noted that some RICs have no ability to control when, or whether, distributions are made and may have income inclusions in excess of available or allowable distributions.

Commenters also suggested that the Non-qualifying Income Proposal would produce inconsistent results. For example, if a RIC has income inclusions with respect to a passive foreign investment company (PFIC) as a result of making a mark-to-market election under section 1296 with respect to the PFIC, the RIC would have qualifying income under section 851(b). See section 1296(h), which specifically treats that income as a dividend even though there has been no distribution. In contrast, if the RIC had made a qualified electing fund election under section 1293 with respect to a PFIC, then the Non-qualifying Income Proposal would prevent income inclusions with respect to that PFIC from being qualifying income.

The Treasury Department and the IRS have carefully considered the comments and recognize that the Non-qualifying Income Proposal creates an unintended effect on the RIC income test of section 851(b)(2). For example, certain types of income, such as interest and dividends, would be considered qualifying income if earned directly by a RIC. These types of income, however, would not be qualifying income when received by a controlled foreign corporation or PFIC and included in a RIC's income under section 951(a)(1) or 1293(a), unless there is a corresponding distribution. Accordingly, the Treasury Department and the IRS have decided not to include the Non-qualifying Income Proposal in these final regulations.

One commenter further recommended that the final regulations treat inclusions under sections 951(a)(1)(A) and 1293(a) derived with respect to a RIC's business of investing in stock, securities, or currencies as other qualifying income for purposes of the RIC income test of section 851(b)(2) (Qualifying Income Proposal). The Treasury Department and the IRS recognize that inclusions under sections 951(a)(1) and 1293(a) with respect to which there are no corresponding distributions may be accelerations of income derived from stock that otherwise would be recognized as a dividend or as gain from the sale or other disposition of stock. The Qualifying Income Proposal recommended by the commenter would treat these inclusions as qualifying income for purposes of section 851(b)(2). That is, it would apply to inclusions with respect to which there are no corresponding contemporaneous distributions and which otherwise would not be treated as dividends even though those inclusions are connected to a RIC's business of investing in stock, securities, or currencies. After further consideration of the issues raised by the commenter and the provisions in "An Act to provide for

reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” P.L. 115-97, title 1, §11000, 131 Stat. 2054 (Dec. 22, 2017), affecting the taxation of income earned outside of the United States, the Treasury Department and the IRS adopt the Qualifying Income Proposal in the final regulations.

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

Because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

Statement of Availability of IRS Documents

The IRS revenue procedures and revenue rulings cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at www.irs.gov.

Drafting Information

The principal author of these final regulations is Matthew Howard, Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.851-2 is amended by revising paragraphs (b)(1) and (b)(2)(i), and adding paragraphs (b)(2)(iii) and (d) to read as follows:

§1.851-2 Limitations.

* * * * *

(b) * * *

(1) General rule. A corporation will not be a regulated investment company for a taxable year unless 90 percent of its gross income for that year is income described in paragraph (b)(1)(i) or (ii) of this section. Any loss from the sale or other disposition of stock or securities is not taken into account in the gross income computation.

(i) Gross income amounts. Income is described in this paragraph (b)(1)(i) if it is gross income derived from:

(A) Dividends;

(B) Interest;

(C) Payments with respect to securities loans (as defined in section 512(a)(5));

(D) Gains from the sale or other disposition of stocks or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended);

(E) Gains from the sale or other disposition of foreign currencies; or

(F) Other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to a regulated investment company's business of investing in such stock, securities, or currencies.

(ii) Income from a publicly traded partnership. Income is described in this paragraph (b)(1)(ii) if it is net income derived from an interest in a qualified publicly traded partnership (as defined in section 851(h)).

(2) * * *

(i) For purposes of section 851(b)(2)(A) and paragraph (b)(1)(i)(A) of this section, amounts included in gross income for the taxable year under section 951(a)(1)(A) or 1293(a) are treated as dividends only to the extent that, under section 959(a)(1) or 1293(c) (as the case may be), there is a distribution out of the earnings and profits of the taxable year that are attributable to the amounts included in gross income for the taxable year under section 951(a)(1)(A) or 1293(a). For allocation of distributions to earnings and profits of foreign corporations, see §1.959-3.

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(iii) If an amount is included in gross income under section 951(a)(1) or 1293(a) and is derived with respect to a corporation's business of investing in stock, securities,

or currencies then the amount is other income described in section 851(b)(2)(A) and paragraph (b)(1)(i)(F) of this section. Notwithstanding paragraph (d) of this section, a taxpayer may rely on the rule in this paragraph (b)(2)(iii) for taxable years that begin after September 28, 2016.

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(d) Applicability date. The rules in paragraphs (b)(1) and (b)(2)(i) and (iii) of this section apply to taxable years that begin after **[INSERT DATE 90 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Kirsten Wielobob

Deputy Commissioner for Services and Enforcement.

Approved: February 15, 2019

David J. Kautter

Assistant Secretary of the Treasury (Tax Policy).

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